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15 April 1987

BERMUDA: IMPLICATIONS OF FAILURE TO RATIFY
US-UK (BERMUDA) TAX TREATY

Summary

Bermuda's concerns over the US-UK (Bermuda) tax treaty reflect the importance that insurance companies have in the island's overall economic performance. The departure of a significant number of insurance companies would certainly result in sizable job and government revenue losses. To put this in context, the US Chamber of Commerce estimates of 200 companies leaving the island would probably translate into a 3 to 4 percentage point drop in GNP growth rates annually over the next two years. While this probably overstates the number of firms that might leave, it nevertheless illustrates the economic impact that the tax issue could have in Bermuda.

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Although Bermudian Premier John Swan has threatened to retaliate for US inaction on these issues by charging the United States rent for its three naval bases on the island, Bermuda is legally constrained from such action because it is a dependent territory of the United Kingdom. A worst case economic downturn would, however, provide strong impetus to Swan's push for Bermudian independence from the United Kingdom, in our opinion, and anti-US sentiments could build to the point that a referendum on independence would be approved within the next year. We believe the process of gaining independence would take at least another year, however, giving the United States some breathing space to negotiate a basing agreement with Bermudian officials.

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This typescript was requested by Ford Cooper, Director, Office of European Affairs, Department of State, in response to specific questions about the economic fallout and possible retaliation by Bermuda if the tax treaty is not ratified. The analysis in this paper is based solely on information provided by the US Consulate in Bermuda and US Treasury officials. It was prepared by [redacted] Middle America-Caribbean Division, Office of African and Latin American Analysis. Comments and queries are welcome and may be directed to the Chief, Middle America-Caribbean Division [redacted]

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Background

Bermuda, citing tax advantages the United States has provided to Barbados, is pressing for US Senate ratification of the US-UK (Bermuda) tax treaty and approval of exemptions to recent US tax reforms for some 700 US-owned insurance firms on the island.¹ Since early last year, Premier Swan, in private conversations with US officials, has threatened to charge rent for the three US naval bases on the island to offset income from the insurance industry lost by non-ratification of the treaty.

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The imbroglio reflects the key role the insurance companies play in Bermuda's economy. According to the US Consulate, US-owned firms account for the vast majority of foreign insurance companies operating in Bermuda. Together, they contribute 40 percent of the island's GNP and 10 percent of government revenues, according to the US Consulate. In addition, the Consulate reports that these firms provide directly and indirectly about 20 percent of Bermuda's jobs, including a large number of professional and managerial positions filled by local employees.

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Economic Considerations

Although we believe Bermuda's concerns over the impact of non-ratification of the treaty are overdrawn, they are not without basis. For example, the president of the US Chamber of Commerce in Bermuda has asserted that 200 insurance companies would close and leave during the next two years if the treaty was not ratified. We estimate that the departure of this number of insurance firms could directly cost Bermuda roughly \$65 million in earnings and cause the island's economy to decline by as much as 3 to 4 percent annually over the next two years.² We believe that this could represent a worst case scenario, however. Even if 200 US firms did leave--and we believe the figure may be exaggerated--Bermuda's earnings from tourism have been increasing steadily and this would help cushion the immediate impact of the departure of insurance firms.

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Threat to US Bases

Although Swan has threatened to charge rent for the US naval bases in Bermuda, he cannot do so unless the island gains its independence from the United Kingdom. As a dependent territory,

¹See the Annex for details on the US-UK (Bermuda) tax treaty.

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²Our calculation assumes that all of these companies contribute the same share to the island's insurance business.

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Bermuda currently is constrained legally from charging such rents unilaterally, but the popular Premier has been pushing hard to gain independence for many years. [REDACTED]

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US failure to extend tax benefits to US-owned insurance companies in Bermuda, in our view, would give his independence campaign a major boost. Swan's efforts last year to launch a referendum on independence were rejected by his party's caucus and the Senate, but public opinion polls at the time showed that independence was opposed by only a small majority of Bermudians. The US Consulate reports that many Bermudians feared that political uncertainty associated with independence could hurt tourism. In addition, we believe that popular concerns about the financial cost of independence also undercut domestic support for a break with the United Kingdom. For example, an independent Bermuda would have to pay for diplomatic representation abroad and its own security protection. [REDACTED]

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If anything close to this Chamber of Commerce projection occurred, however, public anger over eroding living standards and the prospect of charging the US rent for bases probably would outweigh economic and political reservations about breaking with the United Kingdom. We judge that local opposition parties, which have only tacitly supported independence until now, would see little choice but to back a renewed push by Swan for a break with the United Kingdom. [REDACTED]

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Even under such circumstances, we believe the road to independence still would be lengthy. Any move toward a Bermudian national referendum on the issue--a prerequisite to requesting independence--would ignite heated debate over the emotional issue of losing dual Bermudian-British citizenship, according to US Consular officials. We believe this debate would delay Bermudian parliamentary approval of a national referendum. Moreover, a Bermudian legislator estimates that, even after a referendum were held on independence, the promulgation of a constitution would require at least another year. [REDACTED]

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Broader Political Ramifications

Having invested considerable political capital in his campaign for treaty ratification and amendment of the new US tax code, Swan would not take failure lightly. At a minimum, the Premier probably would less readily back Washington on foreign policy issues. For example, Swan has vigorously defended the US military presence in Bermuda and has strongly supported the Strategic Defense Initiative. [REDACTED]

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Non-ratification of the treaty could also have a long-term spillover effect on bilateral US-Bermudian relations. According to the US Consulate, Swan and leaders of the island's opposition parties believe that Bermudian independence is inevitable. Non-ratification of the tax treaty would almost certainly give added

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salience to basing issues in the immediate post-independence period. At a minimum, we would expect an independent Bermuda to demand rent for US bases. Moves to place conditions on US use of its bases on Bermuda also could be expected. Allegations of visits to Bermuda by US nuclear submarines have already been used by opposition political leaders to press for closer monitoring of US military activities on the island. Nevertheless, termination of base rights is unlikely, in our view, if only because of economic reasons. According to the US Consulate, the US military presence contributes roughly \$24 million in cash each year. Washington also underwrites \$15 million of the operating cost of the island's civilian airport, which adjoins the US naval air station. [REDACTED]

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ANNEX

BERMUDA: BACKGROUND ON US-UK (BERMUDA) TAX TREATY

Bermuda, under the aegis of the United Kingdom, early last year successfully negotiated a treaty with the United States that would enable US-owned insurance firms registered in Bermuda to obtain relief from US taxes. In return, Bermuda promised to provide US officials with selected access to banking records.

[REDACTED]

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Bermudian Premier Swan has been pushing the tax treaty because several other countries had received similar US tax concessions. Barbados in 1986, for example, negotiated a treaty with Washington providing concessions for US-registered companies there. Swan claimed--correctly--that the treaty caused a number of companies in Bermuda to relocate in Barbados. [REDACTED]

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Prolonged delays in passage of the treaty, which has been stalled in the US Senate since September 1986, have only increased Swan's resolve to try to maximize tax concessions from the United States. Swan now is also demanding changes in the new US tax code, which negates many of the benefits provided by the treaty. US Treasury officials concede that, unless the tax code is amended, these insurance companies would face much higher taxes even with the treaty. [REDACTED]

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The situation appears to have reached an impasse because of political constraints on both sides. Congress has deferred action indefinitely on the issue because of strong opposition to giving favored treatment to a country with substantially lower income tax rates than those in the United States. Swan, having made ratification of the treaty a priority, now has a large political stake in ensuring its passage. [REDACTED]

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SUBJECT: BERMUDA: Implications of Failure to Ratify US-UK
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